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International Economic & Energy Weekly

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7 March 1986

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International Economic & Energy Weekly [redacted] 25X1

Synopsis

1 **Perspective—Japan: Dawdling on Trade Issues** [redacted] 25X1

Prime Minister Nakasone will find himself in the international spotlight in coming months, with Japan's massive trade surplus almost certainly holding the top position on his—and his trading partners'—agenda. We suspect his emphasis on longer term structural measures may be seen in some Japanese quarters as a way to "buy time" until 1987, when a strong yen may start to reduce Japan's trade surplus with the United States. [redacted] 25X1

3 **Prime Minister Nakasone's Political Agenda** [redacted] 25X1

Prime Minister Nakasone's desire to extend his term as Liberal Democratic Party (LDP) president, and hence prime minister, will dominate both Japanese politics and policymaking through this fall. The common desire to ensure that the Tokyo Summit is a success will give the Prime Minister some breathing room until May after which the political battle lines will be drawn more sharply. [redacted] 25X1

7 **The Rising Yen and Falling Oil Prices: Implications for Trade and Growth** [redacted] 25X1

The actions of Japanese exporters and a sluggish domestic economy will blunt the impact of a stronger yen, and Tokyo's massive trade surplus is likely to grow through 1987. Falling oil prices, however, are unlikely to boost Japan's economic growth relative to that of its major trading partners, although the benefits of lower prices may save Tokyo from having to abandon its commitment to budget austerity. [redacted] 25X1

[redacted] 25X1

15 **Japan's Import Promotion Program: How Effective?** [redacted] 25X1

Unlike earlier efforts, the government's latest import promotion program, which began in April 1985, has some teeth—administrative guidance from MITI urging the country's 134 top exporters to boost imports. The program has met with some success but so far does not appear to have fundamentally changed the business community's attitude. [redacted] 25X1

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International Economic & Energy Weekly [redacted] 25X1

7 March 1986

Perspective

Japan: Dawdling on Trade Issues [redacted] 25X1

Prime Minister Nakasone will find himself in the international spotlight in coming months, with Japan's massive trade surplus almost certainly holding the top position on his—and his trading partners'—agenda. With a trip to the United States likely in mid-April and the economic summit set for Tokyo in May, no doubt he would like to promise that the recent strengthening of the yen will quickly slice the surplus. We do not believe such a forecast can be made in good conscience. [redacted] 25X1

Under the best circumstances, it will take at least a year for yen appreciation to reduce the trade surplus, and these are not the best of circumstances. Many large Japanese exporters are not adjusting prices to fully reflect the yen's new strength. Falling oil prices meanwhile will help exporters compensate for the toll a strong yen is taking on their competitiveness but will not be sufficient to generate a rise in domestic demand that pulls up significantly the level of Japan's imports. [redacted] 25X1

Nakasone will also face difficulty in portraying Tokyo's import promotion schemes and sector-specific trade talks as sure bets to reduce the country's surplus in 1986. The nearly year-old campaign to get top Japanese exporters to buy more abroad has fallen short of its unambitious target. Although Tokyo made numerous concessions in last year's sectoral trade talks with the United States, we do not expect similar talks this year to yield as much. [redacted] 25X1

Partly because of the difficulty of "selling" other approaches, we expect Nakasone will argue that structural adjustment of Japan's economy offers a long-term solution to trade problems. The commission formed by Nakasone to devise ways to reorient growth away from an export-led pattern will make its report by the end of this month. It appears unwilling, however, to advocate sweeping changes in the tax system that would encourage consumer spending and infrastructure investment or discourage investment in export-producing facilities. We expect the commission to endorse less dramatic moves that in the past have done little to remedy trade imbalances. [redacted] 25X1

Nakasone's role in pushing for a structural approach to the trade surplus may be viewed by future generations as an important legacy of the Prime Minister. But we are skeptical that most Japanese government and business leaders genuinely accept this solution. These leaders like the traditional rules of the game that put the burden for adjusting economic policies on the countries running deficits. Although such views have yielded to external pressures before, we doubt the commission's work will be followed by more rigorous proposals anytime soon, barring a resurgence of protectionist sentiment in Washington. We suspect the report may be seen in some Japanese quarters as a way to "buy time" until 1987, when a strong yen may start to reduce Japan's trade surplus with the United States. 25X1

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Prime Minister Nakasone's Political Agenda [redacted]

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Prime Minister Nakasone's desire to extend his term as Liberal Democratic Party (LDP) president, and hence prime minister, will dominate both Japanese politics and policymaking through this fall. This struggle is certain to complicate some policy issues and to make others the objects of increased debate. The common desire among almost all Japanese leaders, to ensure that the Tokyo Summit is a success, will give the Prime Minister some breathing room until May. After the summit, however, the political battle lines will be drawn more sharply. Nakasone is likely to argue for a more open Japanese economy, focusing on medium- to long-term proposals for changes in Japan's industrial structure and macroeconomic policy. For international audiences, he is likely to advertise his policies as broad-based market-opening measures and to downplay sectoral trade issues, such as tobacco, that could expose him to a crossfire of criticism from his LDP rivals as well as foreign trading partners. [redacted]

The Political Arena

Nakasone has publicly denied any plans to run for the LDP presidency when his term expires in October, but virtually all political observers believe he wants to change the party rules that bar him from a third consecutive term. To do so, Nakasone needs a two-thirds majority of LDP Diet members. To boost his chances, the press as well as political insiders speculate that he will call a general election, hoping to lead the ruling party to a major victory before the fall. [redacted]

Elections are already scheduled for the Diet's upper house this June, and Nakasone could argue that the party scored well in the past when upper and lower house elections were combined and that his personal popularity makes such a gamble a good move. If the LDP regained the lower house seats lost in the 1983 election, it would strengthen the Prime Minister's hand. For Nakasone, however, this political strategy depends on the assent of the LDP's senior executives, including his leading rivals, and it is not yet clear that they would support a "double election." [redacted] 25X1

The Prime Minister also could seek a deal with one of his would-be successors—for example, by bargaining for a one-year extension rather than a new two-year term. An extension of his current term, which would allow Nakasone to pursue more of his plans for reforming government operations, would only require a simple majority of party members and conceivably could appeal to other party leaders who want to avoid an all-out succession fight. Finance Minister Takeshita appears to be the most likely collaborator. He commands a majority of the Tanaka faction—the LDP's largest—and is angling to succeed former Prime Minister Tanaka as leader 25X1 of the entire group. [redacted] 25X1

A standoff among Nakasone's opponents represents his best chance to extend his term. His rivals continue to cooperate on most policy issues, but there is no indication that they agree on an orderly succession:

[redacted] 25X1

- Party Vice President Nikaido, the acting head of the Tanaka faction, appears to believe that he can keep control of the faction and compete for the LDP's top job. 25X1

Japan: Liberal Democratic Party Factions, February 1986

	Number of Diet Members [a]	Alignment With Other Factions	Faction Head	Emerging New Faction Leader
Tanaka	121	Linked to Nakasone faction	Susumu Nikaido (acting)	Noboru Takeshita, 60 . . . popular with younger faction members . . . has cultivated good relationships with other factions, parties, and bureaucracy . . . has reduced government spending and budget deficit because of skill in behind-the-scenes negotiations rather than mastery of economics.
Nakasone	64	Tied to Tanaka faction	Yasuhiro Nakasone	
Suzuki	80	Foe of Nakasone faction	Kiichi Miyazawa (acting)	Kiichi Miyazawa, 66 . . . highly respected for intellectual and policymaking abilities but lacks solid party support . . . advocates increased public works spending to solve trade imbalance . . . nationalist on foreign policy issues, dove on defense.
Fukuda	71	Antagonistic to Nakasone-Tanaka alliance	Shintaro Abe (de facto)	Shintaro Abe, 61 . . . skillful at building a consensus . . . prefers to react to issues rather than initiate proposals . . . supports new round of multilateral trade negotiations . . . counts among his advisers a circle of journalists he has known since his days as newspaper reporter.
Komoto	34	Being courted by other factions	Toshio Komoto	

[a] Eighteen LDP Diet members are not affiliated with any faction.

[redacted] 25X1

- Foreign Minister Abe is maintaining a high political profile and running hard to succeed Nakasone, [redacted]

Legislative Scenarios

Nakasone's political prospects will also be shaped by his ability to deal with a number of thorny problems now before the Diet. A Supreme Court decision has again forced the ruling party to face the problem of reapportioning seats in the lower house. The breakup and privatization of Japan National Railways (JNR), tax bills, and possibly education reform are also tough agenda items. [redacted]

For Nakasone, failure to secure passage of a bill to reallocate Diet seats by the close of the current session on 22 May would weaken his position within the LDP as well as undermine his chance to call elections and extend his term. The debt-ridden JNR also presents a serious obstacle for Nakasone, particularly if the LDP fails to reach a consensus on a privatization scheme. Public-sector unions will be affected by the railway reform, raising the possibility that the Socialists—who depend heavily on organized labor—will make the bill a rallying point. [redacted]

With the opposition already calling for large personal income tax cuts in the fiscal 1986 budget, tax issues are certain to prove contentious. Income tax cuts would be politically popular, but Nakasone, his political advisers, and the Ministry of Finance are

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likely to argue that the government's commitment to fiscal austerity precludes this option on anything but a token scale. Instead, we believe Nakasone would prefer to offer an investment tax credit and new incentives for housing construction, which could be portrayed both at home and abroad as economic stimuli. We expect the Prime Minister to unveil such proposals before the June upper house election. [redacted]

On the World Stage

Nakasone has maintained both the political initiative and his high popularity by playing an adroit diplomatic hand. The Tokyo Summit represents his next potential triumph and the linchpin in his strategy to translate his own popularity into another mandate. The recent appreciation of the yen will help Nakasone by taking some of the edge off Japan's trade problems with the United States and other major trading partners. We expect Nakasone to capitalize on the currency issue by emphasizing the need to coordinate international macroeconomic policy at the summit and to downplay sectoral trade disputes. [redacted]

Leading up to the summit, Nakasone will encourage the bureaucracy to make efforts to conclude ongoing trade negotiations, such as those on aluminum tariffs, electronics, and pharmaceuticals. [redacted] Given the political season in Tokyo, we expect the Prime Minister to seek something in return for any Japanese concessions. [redacted]

Nakasone is also likely to attempt to deflect attention from trade problems at the summit by playing up strategic political issues. He probably will make a statement backing some form of participation for Japanese corporations in the strategic defense initiative program (SDI) before then. If the trade discussions become divisive, Nakasone may redouble emphasis on political issues such as terrorism and the need for unity in the Western alliance. [redacted]

Beyond the Summit

[redacted]

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Nakasone will also need to deal with the political consequences of a stronger yen. [redacted] Given the continued calls by LDP politicians as well as Japan's trading partners for Tokyo to expand domestic demand, we expect Nakasone to respond by supporting an easing of monetary policy and by highlighting the benefits of any proposed income tax reductions. The Prime Minister is already under pressure from Finance Minister Takeshita on the growth issue. Takeshita recently captured the limelight—and the credit—by disclosing that the bulk of public works spending in the new fiscal year, beginning in April, will be disbursed during the first half of the year. [redacted]

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Nakasone must keep a step ahead of Foreign Minister Abe in foreign policy as well as deal with competition from Takeshita over economic policy. Nakasone and Abe both are contending for the spotlight in dealing with Moscow, which has moved to warm its relationship with Tokyo. Nonetheless, we expect the Prime Minister to be cautious. Although a Nakasone-Gorbachev summit could further boost Nakasone's popularity, the Prime Minister is well aware that unseemly haste in striking bargains with Moscow would expose him to the charge of sacrificing Japanese interests. [redacted]

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The Rising Yen and Falling Oil Prices: Implications for Trade and Growth

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The actions of Japanese exporters and a sluggish domestic economy will blunt the impact of a stronger yen, and Tokyo's massive trade surplus is likely to grow through 1987. We expect Japan's current account surplus—bolstered by falling prices of oil imports—to approach $60 billion this year, while its trade surplus with the United States [1] may reach $45 billion, a $6 billion increase over 1985 levels. Falling oil prices, however, are unlikely to boost Japan's economic growth relative to that of its major trading partners, although the benefits of lower prices may save Tokyo from having to abandon its commitment to budget austerity.

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Meeting One-Half of a Policy Prescription: The Yen

Economists have long argued that a combination of a strong yen and rapid economic growth, similar to that experienced in 1978-79, is needed to reduce Japan's trade and current account surpluses. The currency appreciation would—after a lag—increase the dollar price of exports and reduce the yen price of imports. An acceleration of economic activity in Japan relative to other nations, moreover, would rapidly boost Japanese imports—especially manufactures—and also divert sales of some Japanese firms from the export to the domestic market. This combination of policies would be especially effective because Japanese exports, except for automobiles, respond relatively quickly to price increases, while Japanese imports respond to increased economic activity.

The first half of this policy recipe is well underway. Since last fall's joint currency intervention by the Group of Five, the yen has appreciated by 25 percent against the dollar and is close to its 1978 record of 176 to the dollar. Small exporters, especially hard hit by the stronger yen, are having trouble signing new contracts for the lucrative Christmas season.

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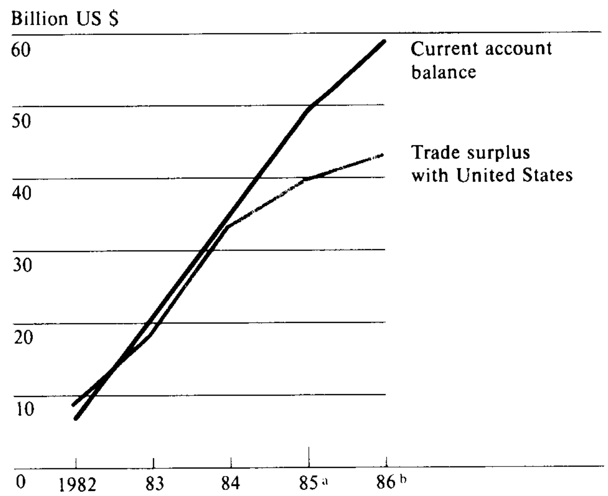
Japan: Current Account Balance and Trade Surplus with the United States, 1982-86



a Estimated.
b Projected.

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Nonetheless, we expect the stronger yen to take a smaller bite out of Tokyo's trade surplus than it did in 1978-79:

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- Major exporters, determined to keep the market-share gains of recent years, are passing only about half the increase in the yen's value to dollar export prices.

[1] We use Japanese trade statistics in this article.

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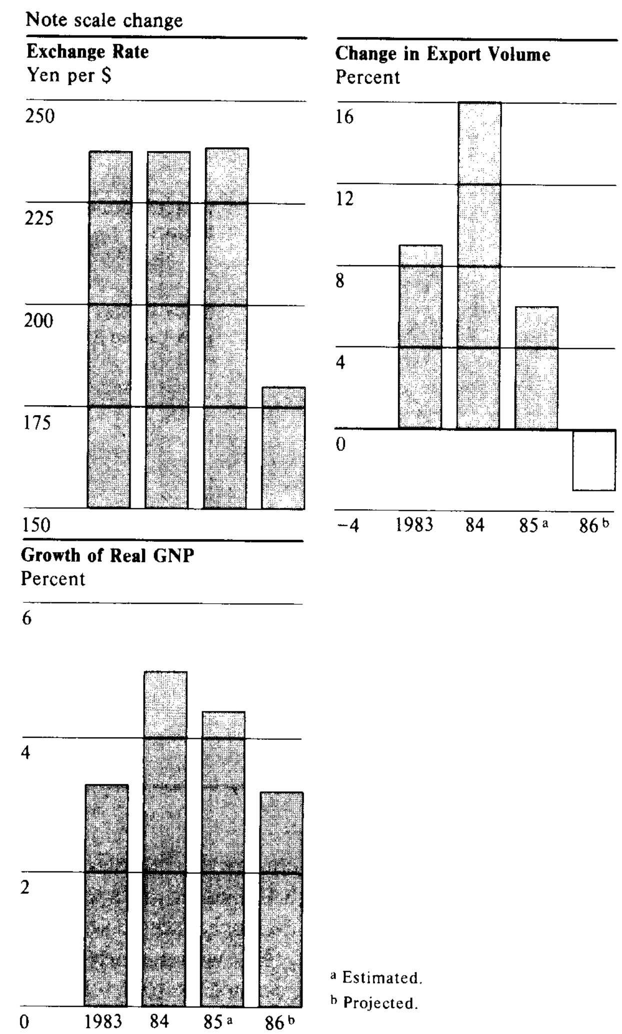
Japan: Economic Indicators, 1983-86



[a] Estimated.
[b] Projected.

[redacted]

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- Since 1979, Japanese companies have reduced the volume of imports used per unit of export goods. [redacted] 25X1

Even Falling Oil Prices Cannot Save Economic Growth

We do not expect Japanese economic growth to complement yen appreciation; instead it will probably slow in 1986 relative to other OECD countries. The factors behind growth over the past two years—booming exports to the United States and China and investment in manufacturing capacity to supply these markets—were slowing even before the yen strengthened. The appreciation has therefore reinforced these deflationary pressures. Because government measures to offset this slowdown are not expected, most private Japanese forecasters believe the official growth projection of 4.0 percent for fiscal 1986—versus 4.4 percent last year—cannot be met. Despite recent promises by Prime Minister Nakasone and other politicians to use fiscal stimulus, any pump-priming measures are likely to be small. The stronger yen has allowed the Bank of Japan to ease monetary policy somewhat, but we doubt lower interest rates will do much to spur economic growth in a country already awash with surplus funds. [redacted] 25X1

Some Japanese policymakers have publicly hinted that a major effort to reflate the economy is unnecessary because the sharp drop in oil prices will do the job. They cite [redacted] 25X1
Japanese studies showing growth rising by a full percentage point in both 1986 and 1987—assuming average oil prices of $20 a barrel. We believe such estimates overstate the impact of falling oil prices on Japanese growth even though Japan depends more on oil imports than any other OECD country. Unless modified, government conservation measures—including heavy taxes on energy use—will limit the drop in retail prices. Japanese utilities also are refusing to pass along to consumers most of 25X1
their windfall gains from lower oil prices. [redacted] 25X1

Outlook: Will 1987 Be Different?

Private Japanese forecasters expect the combination of slower growth and the delayed impact of yen appreciation to push up both the current account surplus and the trade surplus with the United States in 1986, and we agree with this assessment. According to Japanese estimates, the bilateral trade surplus will reach $42-45 billion, while the global current account surplus is expected to jump to $60-65 billion. Any increase in Japanese imports from the United States because of the stronger yen will be muted by the economic slowdown. A substantial portion of manufactures imports, moreover, are used in investment—which is slowing. Consumer spending—another potential source of increased imports of manufactures—is sluggish and is unlikely to revive unless retail oil prices are cut sharply. 25X1

If the yen stays at 180 and oil prices average $20 a barrel, our model indicates that Tokyo's current account surplus will widen to about $65-70 billion in 1987. Next year will probably be the first time the services account goes into surplus, reflecting interest earned on assets abroad. 25X1

The model indicates that Japan's trade surplus with the United States will level off at about $45 billion next year. This forecast may be too optimistic:

- Falling energy costs will make Japanese exporters relatively more competitive, benefiting heavy energy users such as automobile producers. The demise of energy-intensive sectors such as aluminum may also be postponed.

- The investment boom of the past two years has decreased the production costs of major exporters.

- Growing Japanese equity investment in the United States will, at least in the early stages, accelerate imports from Japan. 25X1

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Japan's Import Promotion Program: How Effective? [redacted]

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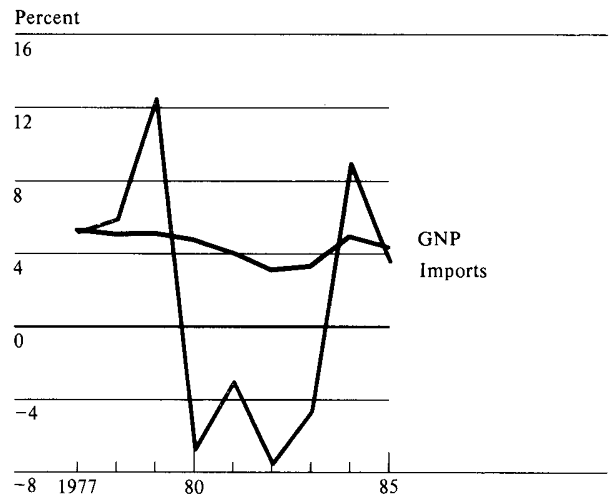
Japan: GNP and Import Growth, 1977-85



[redacted]

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Japan has responded to foreign criticism about the low level of its manufactures imports—roughly half the US level of 5 percent of GNP—by periodically mounting import promotion campaigns. Unlike some earlier efforts, the government's latest import promotion program, which began in April 1985, has some teeth—administrative guidance from MITI urging the country's 134 top exporters to boost imports. The program has met with some success but so far does not appear to have fundamentally changed the business community's attitude. Indeed, the mixed results raise some doubt about whether administrative guidance could play an effective role in boosting imports if Tokyo reversed its current position and decided to adopt formal import targets. [redacted]

A New Variation on an Old Theme

Many of the trade packages unveiled by Japan since 1978 have included programs to increase manufactures imports. Some measures were merely cosmetic, such as exhibitions of imported products and government-sponsored missions to the United States and elsewhere to look for possible purchases. Others, such as "emergency imports" of uranium ore in 1978 and subsidies for raw materials purchases in 1982, were more substantive. Even so, these policies had little impact on Japan's overall import demand. [redacted]

This track record led Tokyo in 1985 to devise a new plan calling on the country's top exporters to boost their imports of manufactures. The initial administrative guidance, issued in April 1985 by MITI, applied only to Japan's top 60 exporters but was expanded three months later to include 134 companies. The stated goal was to add $7.3 billion to the companies' original import plans for fiscal 1985 (ending 31 March 1986) and thus raise their imports by 7.5 percent—roughly the same rate as GNP growth. To aid this effort, the Japan Export-Import Bank reduced interest rates on its loans to Japanese importers from 7.5-7.8 percent a year to 6.2-6.8 percent. [redacted]

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Success of Program Questionable

The Japanese Government and the private sector have been quick to term the latest campaign a success, but we believe that assessment is too

Japan: Import Plans of Selected Top Exporters

Million US $

	1984		1985 Import Goal	Items to be Purchased
	Exports	Imports		
Toyota	10,400	190	210	Auto parts, gift items
Nissan	8,600	250	270	Supercomputer, auto parts
Honda	5,400	145	158	Auto parts
Hitachi [a]	4,100	228	350	Heavy equipment machinery, communications equipment
Mazda	4,000	100	119	Auto parts, medical equipment
Matsushita	3,700	285	320	Aluminum ore, semiconductors, wood products
Sony	2,600	165	220	Helicopters, household appliances, cathode ray tubes
Toshiba	2,500	285	500	Semiconductors
Nippon Electric (NEC)	2,200	700	800	Semiconductor production equipment, local area network software
Mitsubishi Electric	1,900	240	360	Electronic parts

[a] Hitachi import totals are from United States only.

generous. To support its case, MITI has spotlighted specific big-ticket purchases by key exporters, such as Nissan's purchase of a US supercomputer, and other companies' import plans.[1] In addition, the Ministry claims the ratio of manufactures imports to total imports of 31 percent recorded in 1985—a postwar high—is due to its promotion efforts. In fact, the ratio improved primarily because of the decline in dollar terms of overall imports—manufactures imports were down slightly last year, but they did not drop as much as raw material imports.

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The program could still be deemed a success if it gave US companies a foot in the door in Japanese markets. Anecdotal evidence suggests that to date the program has not been completely successful in this regard either:

- According to the US Embassy, some companies are counting components made in the United States by their subsidiaries as fulfilling import targets.

- Many other purchases are from traditional US suppliers. A Toshiba official told the Embassy that only one of the 10 US companies with which it signed contracts on an October 1985 shopping trip was a new supplier.

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Worrisome Implications for Import Targets

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The current import promotion exercise is an important harbinger of the success of any more general import target program. Tokyo remains adamantly opposed to import targets, but, if that policy ever changed, we believe administrative guidance would be forced to play a key role in implementing a target scheme. For example, a strong yen and significant government pump priming by themselves would be unable to boost Japan's share of manufactures imports to the US level of 5 percent of GNP. On the basis of our model of the Japanese economy, we estimate that a 10-percent nominal annual increase in government spending and a yen exchange rate of 180 to the dollar would push

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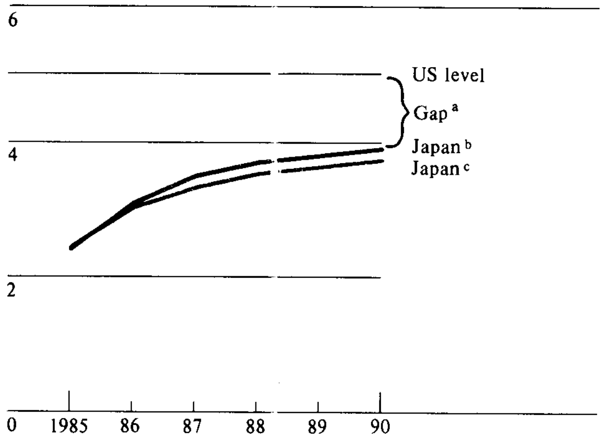
Japanese Import Targets: The Potential Role of Administrative Guidance

Manufactures imports as a percent of GNP



[a] Potentially to be filled by administrative guidance.
[b] Assuming a 180-yen-per-dollar rate and 10 percent fiscal stimulus.
[c] Assuming a 180-yen-per-dollar rate.

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Japanese manufactures imports to 3.9 percent of GNP by 1990 compared to the present 2.4-percent ratio. In our view, import promotion measures, relying on government administrative guidance, would probably have to make up the difference.

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Briefs

Energy

Ignoring OPEC Calls for Production Restraint

Despite continuing pressure from OPEC members, there is no indication that significant voluntary or coordinated production restraint by non-OPEC producers is in the offing. Non-OPEC free world production, including net Communist exports, has reached 27 million b/d and net exports are now 6.5 million b/d. For OPEC to maintain current output without causing further price declines, non-OPEC producers would have to slash net exports by more than one-third, an unacceptably large reduction. Non-OPEC producers are a disparate group with a relatively small share of world oil trade and no formal mechanism for communication or coordination. The United Kingdom and Norway continue to be the focal point of OPEC criticism. Both, however, are sticking by their longstanding policies of not interfering in the oil market. LDCs, striving for energy self-sufficiency and needing the oil export earnings, are also unlikely to reduce output significantly. Competitive pressure and marketing problems may nevertheless cause some involuntary production cuts in the months ahead and force more flexible pricing arrangements. The impending seasonal decline in demand of up to 3 million b/d could temporarily push spot prices for some crudes as low as $10 per barrel in the next few months. Consequently, world oil prices are likely to average below $20 per barrel this year. 25X1

USSR Resumes Crude Oil Sales

Moscow reportedly is again selling crude oil in Western Europe, after virtually disappearing from the market in mid-January. The trade press reports that Soviet crude deliveries to the West—already depressed because of production difficulties—nearly ceased when Moscow refused to make its price competitive. Since mid-February, however, the USSR has sold Soviet crude at less than $18 per barrel to at least two West European contract customers. Moscow's initial refusal to lower its price probably reflected hopes that world price declines would be temporary. Slightly increased Soviet oil production during January, the pressing need for hard currency, and recognition that crude oil prices might fall even further probably caused the USSR to accept a lower price. Moscow nevertheless may still resist offering its other contract customers similar terms or reentering the spot market. 25X1

France and Algeria Haggling Over Gas Deliveries

The French state gas company may refuse to honor a contract for over 8 billion cubic meters per year of Algerian liquefied natural gas if prices are not reduced, according to the US Embassy in Paris. The present contract is take or pay. The company claims it has the alternative sources to withstand a long interruption in Algerian gas deliveries. Algeria's insistence on linking its gas prices to official OPEC crude oil prices rather than to market prices makes its gas as much as 40 percent more costly than Dutch, Norwegian, or Soviet supplies. The French threat may be a ploy to force Algiers to lower its price in pending contract renegotiations, but Algiers will probably sue under international law if France repudiates the terms of contract. Gas exports to France in 1985 earned Algiers nearly $1 billion and accounted for more than one-third of total Algerian gas exports and about one-fourth of French consumption. [redacted] 25X1

China Delays Nuclear Plant

According to the US Embassy, Chinese nuclear officials recently stated that a lack of capital and foreign exchange will force the government to delay construction of the proposed nuclear power project at Sunan, near Shanghai. The delay represents a constriction of China's ambitious nuclear power program shortly after the French were awarded the contract for China's first nuclear power plant, to be built near Hong Kong. The officials indicated, however, that talks will continue with potential suppliers to find ways of financing the project. [redacted] 25X1

Pakistani Officials Deny Coal Find

Pakistani officials have denied press reports of a large coal find in Chitral. Still, with proved reserves of 102 million metric tons, Pakistan has enough coal to last more than 20 years. Coal consumption is estimated at 2 million tons per year and is projected to grow at about 8 percent annually, according to the Sixth Five-Year Plan. There are an additional 900 million tons of unproved reserves. Shortages of technical and financial resources, however, will prevent Islamabad from exploiting its coal deposits to the fullest, adding to Pakistan's chronic energy shortages. [redacted] 25X1

International Finance

Peru Postpones IMF Visit

President Garcia is further reducing his opportunities for an accommodation with Peru's foreign creditors. US Embassy and press reports say the government has indefinitely postponed the visit of an IMF mission originally scheduled for 3 March. Garcia said he will not ask for new IMF loans because the Fund would insist on terms that would enable it to intervene in Peru's economy. Garcia's postponement is probably a reaction to the Fund's refusal last week to alter repayment terms and its insistence that all arrearages be cleared by 16 April. The President, in an apparent effort to buy time, had announced earlier this month that Peru could pay a small part of its $72 million arrearages to the IMF. The renewed antagonism between Garcia and the Fund will alarm commercial creditors, who may now take independent actions on their loans to Peru. [redacted] 25X1

Zambia Receives IMF Loans

Lusaka's adoption of an austerity budget probably was instrumental in securing new IMF loans totaling $345 million, according to US Embassy reporting. The loans include a $265 million, two-year standby agreement and about $80 million in compensatory financing to help offset low copper export prices. The new budget, which was announced on 31 January, calls for steep cuts in recurrent expenditures to offset falling revenues and rising debt service. As a result, the deficit is budgeted to decline by one-third, compared with 1985, to $275 million. The budget caps a string of major reform measures—highlighted by a foreign exchange auction and steep reductions in consumer subsidies—enacted since last fall in conformance with IMF recommendations. Despite these measures, Zambia continues to face massive foreign debt problems and on 5 March reached agreement with the Paris Club to reschedule its debts over a 10-year period with five years' grace. [redacted] 25X1

International Trade

OECD Reaction to US Investment Initiative

OECD governments were cautious in their initial comments on the recent US demarche for including investment issues in the new GATT round. The EC Commissioner for External Affairs stated that a system of protection for investment is needed. Among the nations responding, Spain has been one of the most supportive. A member of the West German Government said, however, that most EC members believe the US proposals go too far, too quickly and cannot win acceptance by developing countries. Bonn and London also are concerned that hostile reaction toward investment by the developing nations will adversely affect New Round negotiations covering services issues. Most governments believe that, if the United States is determined to bring up investment, it should concentrate on those issues related to trade—incentives, local content, and export requirements—rather than on the more contentious areas such as expropriation or entry barriers to investment. [redacted] 25X1

Global and Regional Developments

[redacted] 25X1

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EC Farm Price Program in Disarray

EC agriculture ministers will probably have an even more difficult time than usual reaching agreement on farm support prices this year. The EC Commission's proposal to freeze most prices and reform provisions of the beef and grain sectors was greeted with universal hostility. West Germany, with elections looming, fears that the grain reforms—a 3-percent tax on production to finance export subsidies, tighter quality standards, and a shortened season during which the EC buys surplus farm production—are tantamount to a price cut that would lower farm incomes. Last year, the EC price negotiations were stymied by a German veto of a small cut in the price of grain. Italy complained that proposed cuts in the prices of Mediterranean products force southern member states to pay for the continued overproduction of northern crops. Despite the opposition, most of the price freeze, if not the reforms, is likely to be approved because of the need to reduce agricultural spending. The EC will still face a $670 million deficit in the agriculture budget caused by the impact of the falling dollar on EC export subsidy costs.

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Reaction to US Request for Textiles Standstill

In response to a US request for bilateral discussions on a three-year standstill on textile exports to the United States, Hong Kong and Taiwan have agreed, but South Korea has rejected the request. South Korea argues that its exports to the United States are already covered by quotas under a six-year bilateral agreement that expires at the end of 1987. South Korean trade officials maintain the standstill would cost Korea about $950 million. Korea's Assistant Trade and Industry Minister stated that there are more pressing issues to resolve, including differences over intellectual property rights and access to Korea's insurance market. In addition, negotiations for renewal of the Multi-Fiber Arrangement (MFA) will begin in April. Although Hong Kong and Taiwan have agreed to discussions, it is unclear how they will respond to the standstill request. The current six-year bilateral agreements allow for 2- to 3-percent growth in textiles exports from Hong Kong and an average 2-percent growth in exports of cotton, wool, and manmade fibers from Taiwan. [redacted]

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Spain Threatens Action Against EC Steel Imports

Madrid has threatened to adopt safeguard measures to slow the rise in steel imports from the EC unless the Community takes action soon. The move is in response to the near doubling to just over 200,000 metric tons of monthly steel imports from the EC during the course of last year. Spain's removal of its compensatory tax on foreign goods and adoption of the EC's less stringent value-added tax has made imported steel more competitive. EC officials blame the surge on Madrid's slowness in installing new customs registration and control mechanisms required by EC membership. This will probably be only the beginning of steel disputes betweeen Spain and its EC partners. The Spanish steel industry is undergoing a major and painful restructuring marked by major plant closings and layoffs. Under the EC accession accord, the Spanish steel industry may continue to receive government aid for three years but also faces quotas on sales to other EC countries. As yet, there are no Spanish import restrictions against EC steel. [redacted] 25X1

International Cocoa Agreement Talks Collapse

Efforts to negotiate a 4th International Cocoa Agreement (ICCA) have broken down in Geneva with the announcement by Ivory Coast, the world's largest producer, that it would not join the proposed new pact. [redacted] 25X1

Negotiators also failed to resolve the split between producing and consuming nations on price stabilization levels and price adjustment mechanisms. The collapse of talks is likely to further weaken cocoa prices, now under $1 per pound. Failure to reach an accord before the current agreement expires on 30 September will force liquidation of ICCO stocks—estimated at 100,000 metric tons or about one-fourth of global stocks—putting additional pressure on prices. [redacted] 25X1

National Developments

Developed Countries

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Japanese Supercomputer Sales Up

Japanese supercomputer sales increased sharply last year—in 1984 only four systems were shipped. Fujitsu, the leading Japanese vendor, has a total of about 20 systems either delivered or ordered to date. Last year, NEC claimed to have sold four systems, of which one has already been installed. In addition, Hitachi installed three supercomputers last year and has orders for at least two more. These sales have been to domestic as well as European and US buyers. By comparison, US firms shipped 38 systems in 1985. Because the Japanese supercomputers are roughly comparable to US systems in performance, we attribute some of the Japanese sales success to their willingness to underprice their US competitors. US supercomputer firms, which are small or lack the financial base to compete successfully in a price war with the Japanese, must maintain a clear-cut performance lead if they are to remain the major suppliers of supercomputers worldwide. 25X1

Italy Taxes Gasoline To Offset Lower Oil Prices

The Italian Government decided late last month to allow businesses to reap the benefits of falling world oil prices but has raised taxes on retail sales of gasoline, diesel fuel, and home heating oil to restrain consumption by households and raise public revenues. Italy still depends heavily on oil imports and stands to benefit more than other industrialized countries from the drop in oil prices. In early February, the Bank of Italy estimated that oil at $18 to $20 per barrel would result in a $9.5 billion savings in Italy's energy import bill in 1986—enough to put the current account into surplus. Although Rome is keeping retail prices high so as not to weaken an already lethargic oil substitution policy, it hopes industry will pass its lower costs on to the consumer to help bring down the annual inflation rate to the targeted 6 percent. 25X1

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New Swedish Export Controls

The Minister of Trade last week announced a new export control decree, effective 1 May. It will require exporters of certain foreign high-technology items with civilian and military applications, such as computers and data-processing equipment, to show permission from the producing country for reexport. Established Swedish firms with a record of protecting COCOM-controlled technology from diversion will be exempt. The decree is designed to stop diverters who use small trading firms to transfer COCOM-controlled equipment through Sweden to proscribed countries. Some Swedish officials fear that this accommodation to the West—particularly the United States—endangers Swedish neutrality. Customs officials and industry, however, favor the controls, which Stockholm hopes will protect Sweden's access to US high technology that is crucial to Sweden's industries, especially the defense sector. 25X1

Less Developed Countries

Nicaragua's Dollar Acquisition Scheme

Managua's national exchange house has recently completed an agreement for a US-based company to handle dollar payments to individuals in Nicaragua. Managua newspapers are advertising phone numbers for the US firm. 25X1

While any influx of dollars that this scheme promotes will barely dent Managua's critical hard currency shortage, transfers of just $80 a month would double the purchasing power of the average middle-class Nicaraguan family. 25X1

Small Salvadoran Coffee Harvest

US Embassy sources claim the 1985/86 crop amounts to just 200 million pounds, almost 30 percent below last year. The coffee harvest—which may be the lowest in 30 years—has suffered because of continued depressed internal prices paid to producers, poor weather, and stepped-up guerrilla destruction of the crop. The Embassy reports that existing stocks and high world coffee prices should keep export revenues about equal to last year's level, but the poor crop would eliminate any possible windfall from the price increases. The poor harvest further weakens President Duarte's austerity program—already under attack from leftist labor and conservatives—which imposed additional taxes on coffee this year to benefit from increased export earnings. 25X1

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Shaky Start for New Honduran Economic Team

President Azcona's appointment of a weak economic cabinet may complicate financial talks with bankers and international donors and undercut business confidence in the new government. The US Embassy reported that Azcona's chief economic adviser was angered by the political nature of some cabinet appointments and referred to the economic team as a "disaster." The Embassy further reported that the cabinet's lack of technical expertise suggests the government may pursue populist policies. The first meeting of the economic cabinet reportedly was spent planning expanded public works projects and new housing construction. The lack of skillful advisers makes it unlikely that Azcona will face pressure from within his government to undertake needed austerity measures and weakens prospects for coherent economic decision making. 25X1

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Ugandan Economic Policies Take Form

President Museveni has declared that his new government's primary economic objective is self-sufficiency. Although citing the importance of economic efficiency and the private sector, Museveni also has said that the government will continue to play an important role in the economy. Cabinet members in discussions with the US Embassy have advocated increases in agricultural producer prices, reductions in government spending, devaluation of the shilling, and a review of all parastatals. The US Embassy reports increased economic activity and business optimism since Museveni took over in January. Nonetheless, coffee exports—which generate about 90 percent of Uganda's foreign exchange earnings—are still lagging because of inadequate transport. Economic recovery is likely to proceed slowly despite the new regime's willingness to cooperate with donors and to encourage private enterprise. The regime must deal with resettlement of thousands of displaced persons, economic rehabilitation of areas savaged by previous governments, and continued violent opposition in the north.

25X1

Mozambique Facing Critical Food Shortages

Mozambique needs almost 200,000 metric tons of additional food aid deliveries between now and the end of June to avoid severe food shortages in urban areas, according to US Embassy reporting. Because deliveries of this size—over and above the amounts already committed—are unlikely on short notice, the Embassy projects that wheat consumption will have to be reduced by two-thirds in March and April, and corn sales will have to be cut by one-half during March through June. The impending shortages are a result of natural disasters in recent years and heavy insurgent activity, which made the 1985 crop one of the worst in 30 years. These factors will continue to depress harvests in 1986, even though rainfall has been only a little below average. As a result, Mozambican requirements for grain will total roughly 600,000 tons for the marketing year beginning in May.

25X1

Indian Budget Shifts

India's FY 1986 (April-March) budget announced last week gives increased spending priority to India's poor and raises duties on some imports. The budget proposes an estimated 65-percent increase in spending on social welfare programs such as employment, education, housing, and rural development. Last year's "supply-side" budget emphasized lower tax rates, which paid off in higher revenues from greater economic activity and tax compliance. This year, New Delhi proposes to increase income tax deductions and ceilings, introduce value-added taxes, and revise the direct tax code in June. Although pleased with the tax measures, the business community is disappointed in proposed increases in duties, higher taxes on foreign joint-venture royalties, and the continuance of a surcharge on corporate income tax. The changed emphasis in this year's budget reflects both the administration's need to burnish its battered populist image and growing concern over the trade balance.

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[redacted]

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Additional Indonesian Budget Cuts

Finance Minister Prawiro last week stated publicly that the continued slide in oil prices may force the government to revise an already severe budget for the fiscal year beginning 1 April. According to US Embassy reporting, Prawiro has targeted further reductions in development expenditures and proposed canceling selected large capital-intensive projects. He also suggested that Jakarta might request aid donors to allow more funding of local costs. In addition, he firmly opposes foreign assistance tied to imports from the donor country. Prawiro's comments reflect the fact that oil revenue shortfalls—oil provides about 70 percent of tax revenues—have effectively curtailed Jakarta's ability to stimulate the domestic economy through expansionary fiscal policy. [redacted] 25X1

Bankers' View of Indonesia's Economic Future

According to US Embassy reporting, leading commercial and multinational bankers believe Indonesia can weather oil prices as low as $15 per barrel without significant drawdowns of foreign reserves—provided Jakarta continues fiscal austerity. On the other hand, they argue that, if prices remain depressed for two years or more, the government could come under considerable pressure to reschedule its $37 billion external debt—debt service payments could reach $4.6 billion by 1988. Although we agree that low oil prices will seriously strain Indonesia's external accounts over the next few months, in our judgment Indonesia should experience gradual improvement in its overall financial position after 1987 as nonoil exports rally following increased economic activity in the industrialized countries spurred by lower energy costs. Although miffed that its creditworthiness is being questioned, Jakarta nevertheless has no interest in joining a debtor cartel or tightening controls on foreign exchange flows, according to the US Embassy. [redacted] 25X1

Communist

Beijing Streamlines Trade Ministry Leadership

Beijing has conducted a shakeup of the Ministry of Foreign Economic Relations and Trade (MOFERT), China's highest trade authority, probably to help it reassert control over the foreign sector. Two of three vice ministers, two of three minister's representatives, and all five advisors were sacked. Minister Zheng Tuobin and Vice Minister Lu Xuejian held their positions, and Representative Wang Pinqing became one of two vice ministers. These changes may be a result of widespread dissatisfaction with MOFERT's inability to manage foreign trade. Critics of Deng Xiaoping's market-oriented economic reform policies blame China's record trade deficit—which reached $13.7 billion in 1985, according to Chinese Customs statistics—on the decentralization of trade authority. MOFERT's high-level personnel changes will have little effect in the near term on China's trade imbalance, however. Many of China's leading state corporations are not subordinate to MOFERT, making it difficult for the Ministry to rein them in. 25X1

China Pushes Rural Reform

China's leadership has praised the successes of last year's rural reforms and stated its determination to continue these policies. A report published by a joint Central Committee and State Council forum on rural work last December emphasized that "there must be no going back" despite problems such as declining grain output and increasing corruption. While no major new reforms were introduced, the document reaffirmed the government's commitment to agriculture, promising that the state will increase its investment in agriculture, channel rural industrial taxes into agriculture, and offer preferential loans and fertilizer subsidies to grain producers. It also encourages the concentration of land into the hands of competent farmers and called for increased aid to poor areas. 25X1

Chinese Feed Grain Trade

Because of record feed exports from the north last year, southern China has had to import considerable quantities of animal feedstuffs in the past few months. According to Chinese statistics, China exported more than 7 million metric tons of corn and soybeans in 1985, most of it to the USSR, South Korea, and Japan. To fulfill these contracts, northeastern grain-producing provinces restricted interprovincial grain sales, which resulted in a shortage of animal feedstuffs in southern China. To counteract the impact on southern China's expanding livestock industry, Beijing has purchased 153,000 tons of US soybeans and 230,000 tons of Thai corn in the last three months. Industry experts expect the Chinese to purchase more soybeans and corn during the coming months. 25X1

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